Commercial Banking Analysis

FDIC Quarterly Banking Profile 4Q15

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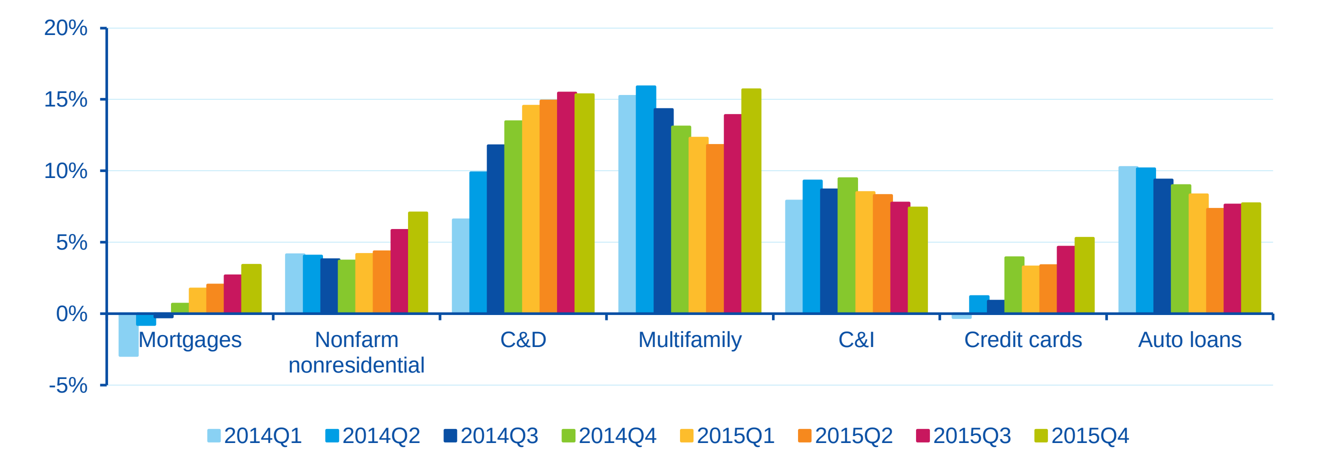
- **Lending grew strongly and asset quality remained solid, except for C&I loans**
- **C&I deterioration was mainly related to commodities**
- **Net income was 11.7% higher YoY, but unchanged from Q3 due to larger provisioning**
- **We expect faster deposits growth and slower C&I and CRE loans growth in 2016**

The Federal Deposit Insurance Corporation (FDIC) Quarterly Banking Profile (QBP) for 4Q15 showed that banks and savings institutions enjoyed a positive last quarter in 2015. However, the industry did not post significantly higher net profit compared to the previous three quarters due to higher provisioning and the first quarterly year-on-year (YoY) increase in charge-offs in 5.5 years – a result of the industry's C&I portfolio deterioration.

Balance Sheet: Lending Continues to Grow at a Solid Rate

Lending expansion continued and even accelerated in the fourth quarter, with gross and net total loans and leases growing at around 6.5% YoY. Construction and development, as well as multifamily residential loans, grew the most (Chart 1), but they represent relatively small shares of the banking sector's balance sheet. The volume of residential mortgages (1-4 family) on the industry's balance sheet increased by 3.4%, driven by both refinancing and purchase originations. Refinance originations increased 43% YoY, which was likely a result of homeowners trying to refinance before the Fed started increasing interest rates. Purchase originations increased 20% YoY, a result of solid increases in home prices and home sales. We expect the growth in

Chart 1
Main Loan Categories
% YoY

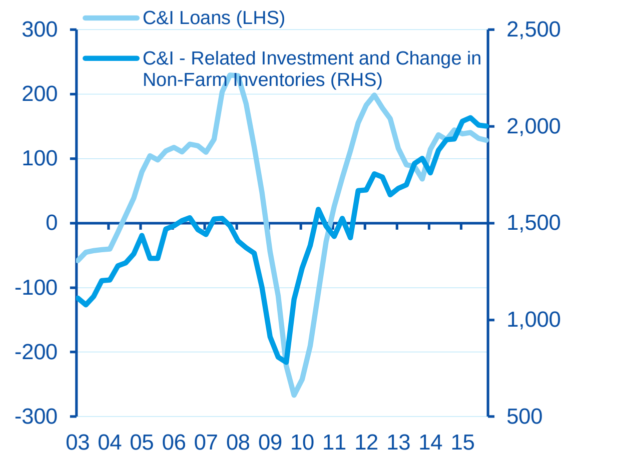


Source: FDIC, BBVA Research

refinance originations to slow down in 2016, while purchase originations should continue to grow at a solid rate, though slowing somewhat. Although commercial and industrial (C&I) loans grew 7.9% YoY, the growth continued slowing down, as the signs of strain in the C&I portfolio intensified and as the growth in C&I-related investment and inventories slowed in the second half of the year (Chart 2).

The quality of funding improved as deposits at domestic offices grew at 5.2% YoY, compared to 2.7% for total liabilities. However, the cost of funding also increased slightly as the ratio of interest-bearing deposits to assets increased. The capital ratios for the industry, while still solid, deteriorated slightly as a result of the strong growth in lending.

Chart 2
Change in C&I Loans and C&I-related Private Domestic Investment and Nonfarm Inventory
$ Billion YoY

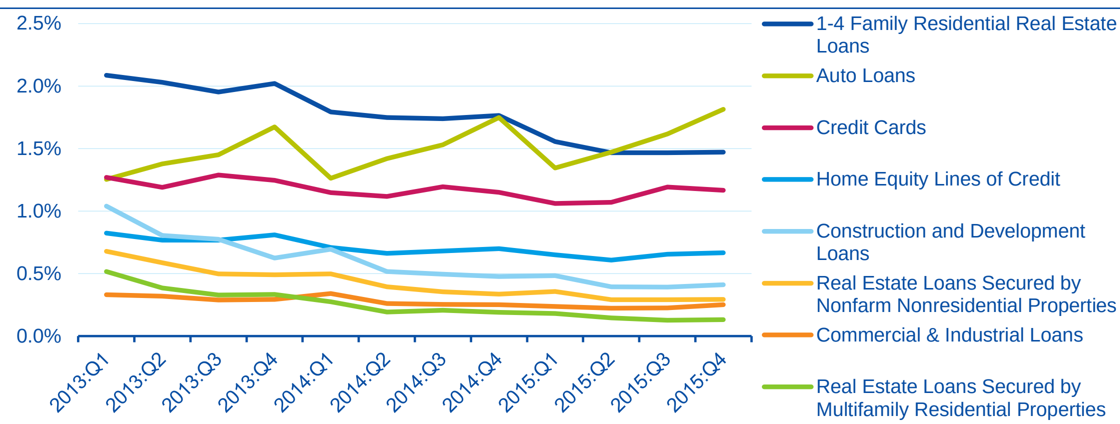


Source: FDIC, BBVA Research

Loan Performance: C&I Deterioration Still Likely Limited to Commodities

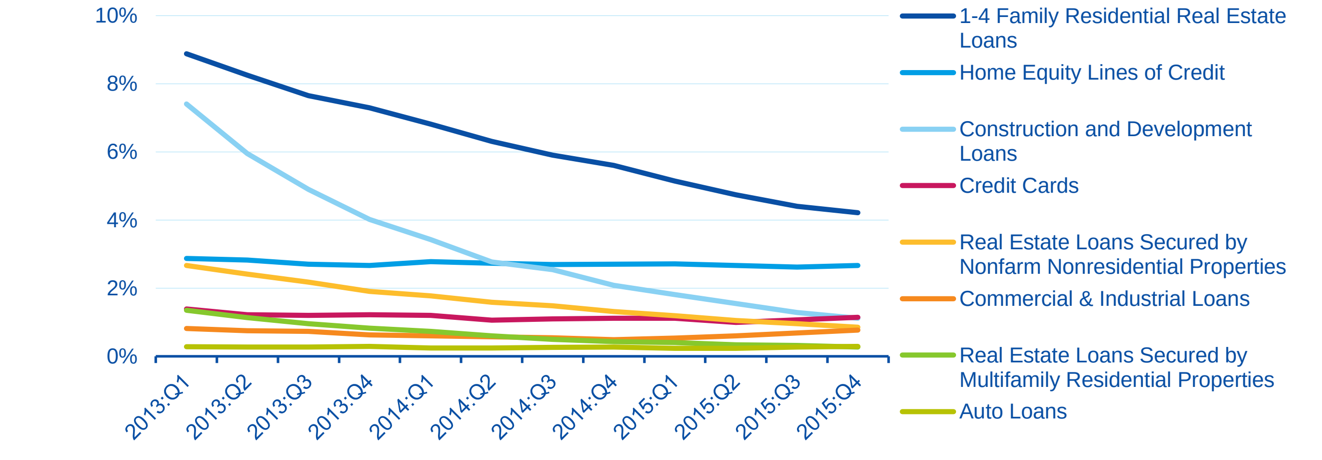
While the quarterly uptick in the shares of loans 30-89 days past due (Chart 3) in auto loans, credit cards and home equity lines of credit was due to seasonality, there seems to be an upward trend in auto loans past due. However, the non-current rate for auto loans is very low (0.3%) compared to other loan categories and does not deviate much from its historic values (Chart 4), so this is not alarming, as long as future developments do not show continued deterioration. The largest development in regards to non-current loans (90 days or more past due and in nonaccrual status) was the continued deterioration in C&I loans, as the C&I non-current rate grew throughout 2015. This deterioration was concentrated in banks with assets larger than $1 billion, indicating that it was related to the financing of larger projects.

Chart 3
Loans 30-89 Days Past Due
%



Source: FDIC, BBVA Research

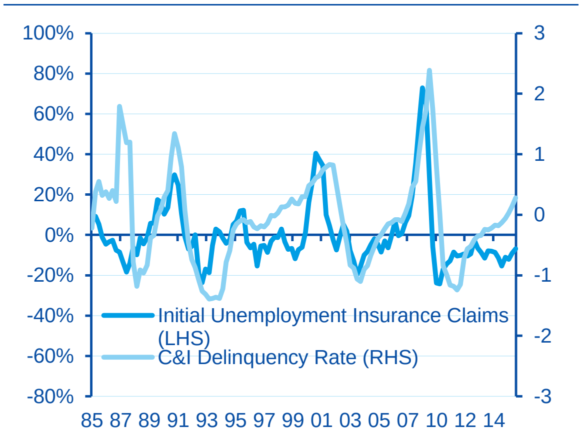
Chart 4
Non-Current Loans
%



Source: FDIC, BBVA Research

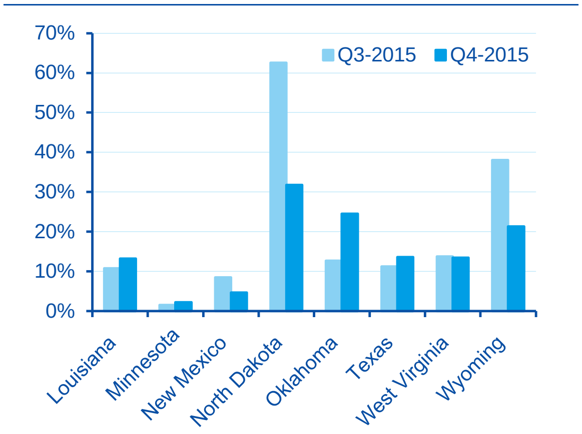
The rise in C&I delinquencies coincides with the downturn in the oil and gas industry, which started in mid-2014. Delinquencies are correlated with initial unemployment insurance claims (Chart 5), so one way to identify where the C&I delinquencies are originating from is to look for states that have experienced increased initial claims. Looking at state-level data, only 8 out of 51 states had increasing initial claims in both Q3 and Q4: Louisiana, Minnesota, New Mexico, North Dakota, Oklahoma, Texas, West Virginia, and Wyoming (Chart 6). All except Minnesota are disproportionately exposed to the downturn in the oil and gas industry, or in the case of West Virginia, the downturn in the coal industry.

Chart 5
Initial Unemployment Claims and C&I Delinquencies
% YoY Change and Percentage Points YoY Change



Source: Department of Labor, FDIC, BBVA Research

Chart 6
Initial Unemployment Claims by State
% YoY



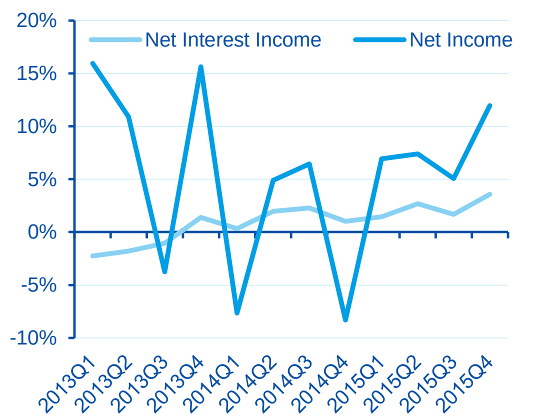
Source: Department of Labor, BBVA Research

The timing of the increase in delinquencies, the fact that they are concentrated at larger institutions, and the geographic concentration of the growth in initial unemployment claims, leads us to the conclusion that the increase in C&I delinquencies is still predominantly commodities-related, even though there is likely some spillover into other sectors in the regions that are heavily exposed to the oil and gas and coal industries. Thankfully, the exposure of the banking sector to this type of loans is not too big, as C&I loans represent less than 12% of total assets, and loans to commodities firms are just a part of that. In the April 2015 Survey of Senior Loan Officers, more than 80% of respondents said that oil and gas lending accounted for less than 10% of their C&I loans outstanding. Based on this, we can estimate that oil and gas-related lending—the biggest share of the commodities-related lending—should not represent more than 1.2% of the banking industry's balance sheet. A large part of these loans are secured. The FDIC chairman's comments on loss provisions and charge-offs made during the presentation of the Q4 QBP indicate that, at this point of time, the agency does not see evidence of significant adverse developments in other industries.

Quarterly Income: Net Income Significantly Higher YoY but Flat QoQ

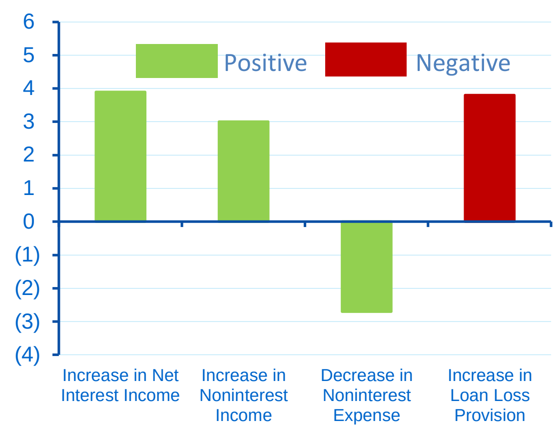
Net interest income increased QoQ, reflecting growth in lending, while net non-interest income remained almost unchanged, as did non-interest expenses. However, as loan loss provisions increased, total net income came in flat compared to the quarter before. Although net income grew by 11.9% YoY (Chart 7), this was to a large extent due to the industry's poor performance in Q4 2014. The major factors that contributed to the large earnings growth on a YoY basis were the increase in net interest income and non-interest income, and the decrease in non-interest expense, which were big enough not to be offset by the increase in loan loss provisions YoY (Chart 8).

Chart 7
Net Interest Income and Net Income
% YoY



Source: FDIC, BBVA Research

Chart 8
Major Factors Affecting Earnings Contributions to Pre-Tax Earnings Growth Compared to Q4 2014
$ Billion



Source: FDIC, BBVA Research

What Can We Expect in 2016?

We expect deposits to grow faster in 2016, supported by sustained economic growth and rising interest rates. On the lending side, we expect total loans to grow at approximately the same rate as in 2015. We expect that growth in C&I and CRE loans will slow somewhat, while credit card and multifamily property loans grow faster. We expect auto loans to continue growing at a similar rate as in 2015, as long as the auto loan portfolio quality does not deteriorate further. Despite the lift-off of interest rates by the Federal Reserve, which should continue in 2016, there will still be pressure on the industry's net interest margins, especially as we expect the yield curve to continue flattening. The low interest rate environment will likely result in the replacement of maturing higher margin loans with lower margin ones. The trajectory of loan loss provisions and charge-offs should remain upward, as we are in an advanced stage of the credit cycle. All these factors will limit the upside for the financial performance of the industry. On a positive note, as of this moment, we do not expect that the risks emanating from commodities will spread to other parts of the banking sector's portfolio, but this will ultimately depend on whether commodities prices go down further or remain at current levels for a long time. We find that commodities-related lending represents a manageable share of the banking industry's balance sheet, and a large part of it is secured. Therefore, we don't expect that the banking industry's exposure to these loans can cause systemic risk at this point of time.